Minutes Of The Meeting Of The
Treasury Borrowing Advisory Committee
Of The Bond Market Association
August 1, 2006

The Committee convened in closed session at the Hay-Adams Hotel at 11:35 a.m. All Committee members were present except Ina Drew. Under Secretary Randy Quarles, Assistant Secretary Emil Henry, Deputy Assistant Secretary James Clouse and Office of Debt Management Director Jeff Huther welcomed the Committee and gave them the charge.

As background to the discussion of the questions in the charge, Director Huther began by briefly presenting the August Quarterly Refunding charts found at http://www.treas.gov/offices/domestic-finance/debt-management/qrc/2006/2006-q3-chart.pdf

The Committee then addressed the first question in the Committee charge (attached) regarding the development of a framework for evaluating Treasury's liability portfolio. Deputy Assistant Secretary Clouse presented a series of slides regarding Treasury efforts to develop an analytical framework for evaluating Treasury's portfolio choices on issues such as maturity composition, the appropriate mix of nominal versus inflation-protected securities, and other aspects of debt management.

DAS Clouse described the preliminary version of the model that the Office of Debt Management has been constructing. Key inputs to the model include GDP, CPI, deficits, nominal and real yield curves, interest-rate volatilities and the auction calendar. The model's independent variable is the mix and type of securities issued. Key outputs from this model are "steady state" (long-term) portfolio characteristics, mean and variance of interest costs, and debt turnover.

The model could be used to develop a baseline scenario from which alternative financing strategies can be evaluated. Some examples of the types of analytical measures that can be obtained from the model included debt-to-GDP ratio, mean interest cost, interest cost "smoothness", interest cost uncertainty, deficit uncertainty, and cash balance uncertainty. Once a baseline is established, Treasury could use the model to assess the impact of adding or eliminating new securities, altering the auction schedule, understanding the effects of changes in economic parameters, and better understanding of certain tail risks. DAS Clouse showed example charts where scenario analysis had been done assuming a short and longer-term bias in the maturity of securities issued by the Treasury.

In their discussion of the model, members suggested the need to better define model constraints, including capturing Treasury's desire for flexibility given the volatility of the fiscal situation. Another member suggested that deficit uncertainty is the biggest factor in this kind of model and getting a better sense on the link between GDP and tax receipts would be beneficial. It was also noted that the model appeared to be highly sensitive to interest-cost factors and that those factors would overwhelm the model outputs in a manner that may push Treasury to borrow short-term, without fully modeling the risks of shorter-term borrowing. Another member suggested that Treasury needs to better define forecast horizons, prioritize magnitudes of risk constraints including the nature of the risk (symmetrical or asymmetrical), and get a feel for the variance of the risks in order to have a more meaningful model, which would reflect Treasury's concern regarding rollover risk, tail events, and the need for a balanced portfolio.

One member asked why average maturity was not a factor in the model. Director Huther indicated that average maturity was a proxy for interest-cost volatility measures and that interest-cost volatility was measured directly in the model. DAS Clouse indicated that the model could be enhanced in the future to supply more metrics.

A member asked when Treasury thought the model would be out of the preliminary stages and in a production stage. DAS Clouse thought that the development of the model would be an evolving effort, where feedback from the Committee would be sought continuously, but that in 2007 a production model may be available.

The Committee then addressed the second question in the charge regarding shifting to a quarterly issuance cycle for 30-year bonds beginning in February 2007. Director Huther presented two slides describing the effects of quarterly bond issuance. The first slide highlighted the increase in the risk to dealers as measured by the dollar value of a basis point (DV01) and how that risk had increased since the reintroduction of the 30-year bond. The second slide showed the impact of quarterly issuance on the average maturity. Because of concern over minimum auction sizes necessary for liquidity, the total annual issuance of 30-year bonds would rise slightly from current levels if Treasury went to quarterly issuance, increasing average length.

The Committee began to discuss market activity in the long end. Some members felt that active trading was less important in the long-end of the market than at other points on the curve. There was fundamental demand for the bond from investors that want to buy and hold the bond which explains some of the lower trading volume. One member noted that market activity long-end was less about trading demand and more about hedging demand. Another member noted that international buying was occurring in the intermediate sector of the curve so there may be less volatility of demand at the long-end of the curve.

Members also noted that many corporate issuance hedgers had not rolled into the new 30-year bond but continued to hedge using the Feb 2031 issue. It was suggested that reason that hedgers had not rolled into the new bond was because hedgers know the investors that lend the Feb 2031 bonds and can more easily reverse in the bonds from those owners when they need them for hedging purposes.

Other members commented that active trading was still important in the long end and cautioned about going too low in auction sizes, noting that an active Treasury market supports swaps, futures markets and other financial derivatives markets.

Members noted that pension fund demand for bonds, while not as robust as the initial auction in February suggested it would be, would nevertheless constitute a strong source of demand at some future point.

Members generally felt that the market was not expecting quarterly issuance of 30-year bonds, and there was currently not overwhelming demand for 30-year bonds, but that markets were expecting Treasury to make a statement regarding the creation of a May/November coupon cycle so as to fill out the STRIPS market. To the degree that quarterly issuance is one means of creating a May/November cycle, the decision to do quarterly issuance would probably not shock the market. Another member suggested that having just brought the bond back in February, it may be too early to make the decision to go to quarterly issuance; that a decision so soon would perhaps run counter to Treasury's policy of "regular and predictable" changes in debt management. Another member suggested that going to quarterly issuance, which would involve increasing issue amounts, while borrowing needs were falling and bills outstanding were historically low, may be interpreted by some market participants as market timing by Treasury.

Next, the Committee was asked about the appropriate role of Treasury in deterring artificial reductions in the floating supply of particular securities in the Treasury market. Director Huther emphasized that Treasury recognizes the value of unfettered trading in the market, and that Treasury was largely concerned with appropriate responses when developments may impair market liquidity and ultimately increase the Treasury's cost of borrowing.

Director Huther outlined the current tools for addressing the artificial reductions in supply including "jawboning" i.e., talking with market participants, large position reporting, or reopening issues. The Committee generally felt that the market works very well and that the bar should be very high before there is intervention by Treasury, and that Treasury had the appropriate tools for dealing with this. One member noted that there are incentives to move away from highly regulated markets and that Treasury should not do anything to increase regulatory burdens. The Committee generally felt that the only time Treasury should step in is if there were systemic problems, such as significant amounts of fails.

Finally, the Committee discussed its borrowing recommendations for the August refunding and the remaining financing for this quarter as well as the October – December quarter. Charts containing the Committee's recommendations are attached.

The meeting adjourned at 12:50 p.m.

The Committee reconvened at the Hay-Adams Hotel at 6:00 p.m. All the Committee members were present except for Ina Drew. The Chairman presented the Committee report to Undersecretary Quarles. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 6:20 p.m.

Jeff Huther
Director
Office of Debt Management
August 1, 2006

Certified by:

Thomas G. Maheras, Chairman
Treasury Borrowing Advisory Committee
Of The Bond Market Association
August 1, 2006

Attachments:
Link to the Treasury Borrowing Advisory Committee discussion charts

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – August 1, 2006

Portfolio Composition

Treasury continues to develop a framework for evaluating our portfolio of marketable debt securities. Recognizing the limitations inherent in models of this sort, we would like the Committee's suggestions on the types of model outputs that would be useful in guiding future policymaking .

Thirty-Year Bond Auction Cycle Change

We seek the Committee's views on Treasury shifting to a quarterly issuance cycle for 30-year bonds beginning in February 2007. In the context of overall bond market conditions and the Committee's assessment of Treasury financing needs (we believe quarterly issuance would require slightly higher annual issuance to ensure adequate liquidity in the bond sector), does the Committee recommend issuing bonds quarterly or maintaining semi-annual issuance in 2007?

Role of Regulators in the Treasury Market

Several incidents over the past eighteen months suggest that the incentive to artificially reduce the supply of Treasury securities in the financing market has risen with the increases in short term rates. While we recognize the value of unfettered trading in the market, we are also concerned that at times these developments may impair market liquidity and ultimately increase the Treasury's cost of borrowing. We would like the Committee's views on the appropriate role of Treasury in deterring artificial reductions in supply.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $22.4 billion of privately held notes and bonds maturing or called on August 15, 2006.

- The composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills.

- The composition of Treasury marketable financing for the October-December quarter.